

No. 2685

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

W. L. WILSON, EMIL E. LENGUETIN, FRED
F. CONNOR, JOHN A. BLOOM, LAWRENCE
HOBRECHT and BENJ. F. CURRIER,
Petitioners,

vs.

THE CONTINENTAL BUILDING AND LOAN ASSO-
CIATION (a corporation) et al.,
Respondents,

In the Matter of
CONTINENTAL BUILDING AND LOAN ASSOCIA-
TION (a corporation),
Bankrupt.

BRIEF FOR RESPONDENTS.

HELLER, POWERS & EHRMAN,
HUGO D. NEWHOUSE,
REUBEN G. HUNT,
Attorneys for Respondents.

Filed this.....day of March, 1916.

FRANK D. MONCKTON, Clerk.

By.....Deputy Clerk.

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Statement of the Case.

(Italics are ours unless otherwise noted.)

While the statement of the case set forth in petitioners' brief is substantially correct, some material things have been omitted.

The bankrupt is a building and loan association formed under the laws of the State of California.

Its capital stock consists entirely of the dues paid in by its members together with the apportioned profits of the corporation (Trans. p. 39). These associations are essentially corporate partnerships. They have no functions except to gather together in small contributions sums large enough to justify loans and it is out of these loans that they make their profits (Trans. p. 40).

In their petition to this court, petitioners admit that the Continental Building and Loan Association was *duly* adjudged a bankrupt on August 9, 1915 (Trans. p. 1). "Duly adjudged" means that the association presented to the District Court a voluntary petition in bankruptcy in conformity with Official Form No. 2 prescribed by the Supreme Court of the United States by its General Order No. 38, promulgated in accord with the power conferred upon it by Section 30 of the Bankruptcy Act. The petition in bankruptcy in the case at bar, therefore, following this official form, set forth that: "The corporation owes debts which it is unable to pay in full," and was accompanied, in the form of exhibits, by a schedule of liabilities and assets. The only persons listed in these schedules as creditors, to whom the corporation owed these debts, were its shareholders (Trans. p. 48). There are other debts, amounting to \$12,190, owing to so-called "outside creditors", which are not set forth in the schedules, but which are conceded as entitled to priority of payment over the claims of the shareholder creditors (Trans. p. 48).

At the first meeting of creditors held before the referee in bankruptcy on August 30, 1915, T. C. Tognazzi was elected trustee through proxies solicited and voted by James McCullough, the president of the bankrupt corporation. This selection was disapproved by the referee on the ground that it had been brought about by the activity of the officers, directors and attorneys of the bankrupt, and he notified these officers, attorneys and directors that they would not be permitted to participate in the next election or influence claimants as to whom they should vote for in the choice of trustee (Trans. p. 31).

Brief of the Argument.

I. The proceedings on review of the referee's order were regular and not unusual.

II. The finding of the referee, concurred in by the District Judge, that the election of the Anglo-California Trust Company was accomplished through the efforts of the officers and attorneys of the bankrupt, cannot be questioned upon a petition to revise.

Whitla & Nelson v. Boyd, (C. C. A., 9th Cir.)

213 Fed. Rep. 587, 588; 32 Am. B. R. 469, 470;

Good v. Kane, (C. C. A., 8th Cir.) 211 Fed. Rep. 956, 958; 32 Am. B. R. 21;

In re Dorr, (C. C. A., 9th Cir.) 196 Fed. Rep. 292, 294; 28 Am. B. R. 505, 506;

Ohio Valley Bank v. Mack, (C. C. A., 6th Cir.) 20 Am. B. R. 40; 163 Fed. Rep. 155.

III. The liquidation of the bankrupt corporation is not a liquidation between persons constituting the corporation, rather than a liquidation between a bankrupt and its creditors, because, upon the adjudication, the status of the shareholders changed to that of creditors.

In re Hanson, 156 Fed. Rep. 717, 718; 19 Am. B. R. 235, 237.

IV. The rule that officers and attorneys of the bankrupt must not interfere in the election of a trustee, is based upon substantial reasons, which apply in this case as well as in other cases.

In re John F. McGill, 106 Fed. Rep. 57; 5 Am. B. R. 155, 161;

In re Rekersdres, 108 Fed. Rep. 206; 5 Am. B. R. 811;

Falter v. Reinhard, 4 Am. B. R. 782;

In re Henschel, 109 Fed. Rep. 861; 6 Am. B. R. 305;

In re Dayville Woolen Co., 114 Fed. Rep. 674; 8 Am. B. R. 85;

In re Gordon Supply Manufacturing Co., 129 Fed. Rep. 622; 12 Am. B. R. 94;

In re Cooper, 135 Fed. Rep. 196; 14 Am. B. R. 320;

In re Hanson, 156 Fed. Rep. 717; 19 Am. B. R. 237;

In re Sitting, 182 Fed. Rep. 917; 25 Am. B. R. 685;

In re Van De Mark, 175 Fed. Rep. 287; 23 Am. B. R. 760;

In re Wink, 206 Fed. Rep. 348; 30 Am. B. R. 298;

In re Morris, 154 Fed. Rep. 211; 18 Am. B. R. 828;

In re Ployd, 183 Fed. 791; 25 Am. B. R. 196.
Civil Code Cal., Secs. 3510, 3511;

In re Forestier, 222 Fed. Rep. 537, 538;
35 Am. B. R. pages 51, 52;

In re Rekersdres, 108 Fed. Rep. 206; 5 Am. B. R. 811;

Williams on Bankruptcy, 9th Ed. 85.

V. The majority creditors have not been deprived of the right to select a trustee, but must not, as against the objecting minority, select a trustee connected with the former management of the bankrupt, either directly or indirectly.

Gordon Supply & Manufacturing Co., 129
Fed. Rep. 622; 12 Am. B. R. 94;

Woodman's "Law of Trustees in Bankruptcy", Chap. 1, Sec. 11.

VI. Even if the election had not been directed, managed or controlled by the officers of the bankrupt, the Anglo-California Trust Company was disqualified because it is the trustee under all the deeds of trust securing the bankrupt's loans.

Williams on Bankruptcy, 9th Ed., 85;

In re Forestier, (D. C. Cal.) 222 Fed. Rep. 537, 538; 35 Am. B. R. 51, 52;

In re Schulz (D. C. Nor. Dist. Cal., decided May 21, 1915);

In re Clay, 192 Fed. Rep. 830, 833; 27 Am. B. R. 715, 719.

VII. To disqualify a candidate for trustee it is not necessary to show that the activity of the bankrupt actually influenced the creditors—the activity of the bankrupt is enough.

Remington on Bankruptcy, 2nd Ed., Vol. 1, Sec. 887.

VIII. Directors, officers and stockholders of ordinary corporations cannot even vote their individual claims for trustee where there has been collusion or improper influence.

Remington on Bankruptcy, 2nd Ed., Vol. 1, Sec. 887.

IX. Petitioners do not show that they were in anywise prejudiced by the order of which they complain.

X. The referee's ruling was not made for the benefit of anyone other than the stockholders themselves.

I.

THE PROCEEDINGS ON REVIEW OF THE REFEREE'S ORDER WERE REGULAR AND NOT UNUSUAL.

Petitioners commence their brief by stating (Petitioners' Brief, p. 6):

“Some apology is due to the court for the inability of petitioners to present the issues in as clear cut a manner as possible. Our excuse must be the very unusual practice followed in

this case, which merits a word of explanation. The unusual nature of the practice followed consisted in: (1) The failure of the referee to make any finding of fact and to clearly certify the precise question for review; (2) In including in his certificate an extended argument in support of his decision; and (3) In admitting evidence outside of a creditors' meeting and after the original hearing had terminated, after his order of disapproval had been made and after the petition to review had been actually prepared and filed."

Petitioners, however, fail to show wherein they were in any wise prejudiced by these "unusual practices", and an examination of the record will show that petitioners' statement is based upon false premises.

(1) In the first place, the referee, in his certificate, after summarizing the evidence, did make a finding of fact when he stated (Trans. p. 37):

"In my opinion the evidence shows that the officers and attorneys of the bankrupt have dictated the steps leading up to the choice of the Anglo-California Trust Company and evidences a determination on their part to control the administration of this estate in this court."

Judge Dooling put it in another form when he stated in his opinion (Trans. p. 49):

"The selection of the Anglo-California Trust Company was disapproved by the referee because he found that the selection had been influenced, if not brought about, by the officers of the bankrupt and the attorneys for the bankrupt."

The petition for review filed by petitioners with the referee sets up (Trans. p. 17) thirteen alleged errors. In his certificate, the referee does not, it is true, certify each one of the questions presented by these assignments of error, but he consolidates the alleged errors into one question, which is clearly set forth in certificate (Trans. pp. 42-46) and that is: Conceding that ordinarily officers and attorneys of bankrupts cannot influence the appointment of their trustees, does this rule apply in a proceeding of this kind where the shareholders, who are the creditors, themselves chose these officers and attorneys: there being no capital stock other than the dues paid in by the shareholders together with the profits, does not this proceeding partake more of a liquidation between the persons constituting the bankrupt corporation than a liquidation between a bankrupt and its creditors? The entire argument of petitioners in their brief is built up around this question, and so, evidently, petitioners had little difficulty in ascertaining the precise question for review set forth in the referee's certificate.

(2) As to the second so-called "unusual practice", it is quite the common practice for referees to include in their certificates extended arguments in support of their decisions. The books are full of cases where such certificates have been quoted with approval by appellate courts. Petitioners

claim that such a course complicates the presentation of their arguments, by reason of the obvious necessity of their not permitting any of the referee's arguments to go unanswered, thus putting them in the position of having to reply in an opening brief. It occurs to us that, instead of *embarrassing* petitioners, the referee's argument in his certificate gives them a distinct advantage, in that it informs them in advance of the position that respondents must assume, and the cases upon which they must rely.

(3) The third unusual practice is refuted by petitioners' own quotation from the referee's certificate (Trans. p. 34):

"On offering testimony in support of his objection Mr. Hunt stated that he desired to show that Mr. McNab is a director of the Anglo-California Trust Company, and that said company has acted as trustee for the Continental Building & Loan Association, but he needed a continuance to call witnesses for this purpose. I stated that if it became necessary to certify the matter to the court I would permit him to complete the record in this respect. Being satisfied from the evidence already presented that Mr. Hunt's objection should be sustained, I concluded to decide the matter on the record as it then stood."

Surely there was nothing unusual or irregular about the referee's course in this respect.

II.

THE FINDING OF THE REFEREE, CONCURRED IN BY THE DISTRICT JUDGE, THAT THE ELECTION OF THE ANGLO-CALIFORNIA TRUST COMPANY WAS ACCOMPLISHED THROUGH THE EFFORTS OF THE OFFICERS AND ATTORNEYS OF THE BANKRUPT, CANNOT BE QUESTIONED UPON A PETITION TO REVISE.

Petitioners, in their brief, do not attempt to attack this finding, although in one place they make the rather bald statement that there is not one word of evidence that any of the creditors who voted for the Anglo-California Trust Company were actually influenced by the acts of the bankrupt's directors and attorneys (Petitioners' Brief, p. 22).

Upon a petition to revise the Circuit Court of Appeals will consider questions of law only (*Whitla & Nelson v. Boyd*, C. C. A. 9th Cir., 213 Fed. Rep. 587, 588; 32 Am. B. R. 469, 470). Also, upon such a proceeding, findings of disputed questions of fact on conflicting evidence are not reviewable, although the question of law whether or not there was any substantial evidence to sustain such findings can be determined (*Good v. Kane*, C. C. A. 8th Cir., 211 Fed. Rep. 956, 958; 32 Am. B. R. 21).

That there was a conflict in the evidence presented to the referee, involving questions of credibility, appears from the record, although the overwhelming weight of the evidence is in favor of the referee's finding. This is not denied by petitioners. That there is an abundance of substantial evidence to sustain the finding, also appears from the record,

and this, too, is not denied by petitioners. So, therefore, the finding of the referee and the district judge that the election of the Anglo-California Trust Company was brought about by the activity of the officers and directors of the bankrupt, must be taken as established.

Even though the appellate court would consider questions of fact upon a petition to revise, it has been universally held that where the referee and the district judge have concurred upon findings of fact based upon conflicting evidence they will not be reversed except for plain error (*In re Dorr*, C. C. A. 9th Cir., 196 Fed. Rep. 292, 294; 28 Am. B. R. 505, 506). This rule is fully discussed by Circuit Judge Lurton in the case of *Ohio Valley Bank v. Mack* (C. C. A. 6th Cir.), 20 Am. B. R. 40; 163 Fed. 155, where he said:

“No arbitrary rule can be laid down for determining the weight which should be attached to a finding of fact by a bankrupt referee. His position and duties are analogous, however, to those of a special master directed to take evidence and report his conclusions, and the rule applicable to a review of a referee’s findings of fact must be substantially that applicable to a master’s report. *Tilghman v. Proctor*, 125 U. S. 137; 8 Sup. Ct. 894; 31 L. Ed. 664; *Davis v. Schwartz*, 155 U. S. 631; 15 Sup. Ct. 237; 39 L. Ed. 289; *Emil Kiewert & Co. v. Juneau*, 78 Fed. 708; 24 C. C. A. 294; *Tu River Co. v. Brigel*, 86 Fed. 818; 30 C. C. A. 415. Much in both cases must depend upon the character of the finding. If it be a deduction from established fact, the finding would not carry any great weight, for the judge, having the same facts, may as well draw inferences or deduce a

conclusion as the referee. *But, if the finding is based upon conflicting evidence involving questions of credibility, and the referee has heard the witnesses, much greater weight naturally attaches to his conclusion, and the weight of authority is that the district judge, while scrutinizing with care his conclusions upon review, should not disturb his findings unless there is most cogent evidence of a mistake and miscarriage of justice.* Loveland on Bankruptcy, section 32a; *In re Swift* (D. C. Mass.), 9 Am. B. R. 237; 118 Fed. 348; *In re Rider* (D. C. N. Y.), 3 Am. B. R. 178; 96 Fed. 811; *In re Waxelbaum* (D. C. Ga.), 4 Am. B. R. 120; 101 Fed. 228; *In re Stout* (D. C. Mo.), 6 Am. B. R. 505; 109 Fed. 794; *In re Miner* (D. C. Oreg.), 9 Am. B. R. 100; 117 Fed. 953. In this case the conclusions of the referee necessarily involved the credibility of the witnesses who testified to the bona fides of the claim preferred by Charles Mack, Sr. *The conclusion he reached in favor of the validity of his debt has also passed the scrutiny of the district judge. Under such circumstances, this court is not warranted in overturning the conclusions of two courts upon anything less than a demonstration of plain mistake.*"

Lest there be any doubt as to the substantial and sufficient character of the evidence in the record to support the referee's finding, let us briefly review the same, bearing in mind that practically all of the evidence had to be extracted from hostile witnesses.

At the first session of the creditors on August 30, 1915, T. G. Tognazzi was elected trustee upon claims voted for him through proxies obtained for that purpose by James McCullough, the president of the bankrupt corporation. His election was disap-

proved by the referee on the ground that it had been brought about by the activity of the officers, directors and attorneys of the bankrupt, and the referee notified these directors, officers and attorneys that they would not be permitted to participate in the next election or influence claimants as to whom they should vote for in the choice of trustee (Trans. p. 21). No review was taken of this order of the referee, but within twenty-four hours thereafter a meeting of the directors of the bankrupt was held at which Mr. James McCullough, the president of the bankrupt, Mr. Mordecai, a director and a legal associate of Mr. McNab, the chief counsel of the bankrupt, Mr. McNab himself, and Mr. Corbin, a director and the general manager of the bankrupt, were present. At this meeting it was decided to send out and obtain proxies from creditors in favor of Mr. Joseph A. Leonard (Trans. p. 25) for the next election on September 15, 1915. Mr. Leonard is the president and manager of a corporation of which Mr. McNab is a director and the attorney (Trans. p. 36).

Mr. McCullough thereupon notified all the stockholders by circular letter that he would call a meeting to select a new candidate for trustee but did not fix a time and place of meeting. He requested the stockholders, however, not to give their proxies to anyone until after the action taken at this meeting. A meeting was then held of a few stockholders in San Francisco, but it does not appear upon what notice or to whom notice was given, the Continental officers

having failed to enlighten the referee upon that point. This meeting agreed to solicit proxies for Mr. Leonard, the man selected by the directors; and Mr. McCullough thereupon notified all the stockholders to this effect (Trans. pp. 28 and 29). At this meeting, which was held upon extremely short notice, a committee was formed, and this committee, of which Wallace Bradford was chairman, sent out a circular letter to all stockholders requesting proxies to be given to Mr. Leonard and stating that before any trustee was decided upon the stockholders would be notified by mail of the reasons for the recommendation (Trans. p. 35). Mr. McCullough also sent out another circular letter notifying the stockholders of the action taken at the meeting and impliedly soliciting proxies for Mr. Leonard. Notice that these proxies would be voted for the Anglo-California Trust Company was not sent to the stockholders until the night preceding the election, which was to be held September 15, 1915, at 10 A. M. (Trans. p. 35). The Anglo-California Trust Company, for whom Leonard voted his proxies at this second election, is the trustee named in and holds the deeds of trust securing the loans made by the bankrupt. Mr. McNab is a director of the Anglo-California Trust Company and represents it from time to time as an attorney (Trans. p. 34). Notice of the selection of the Anglo-California Trust Company, as the candidate for trustee, was sent out to the stockholders by Mr. Corbin, the general manager of the bankrupt, on the night of September 14th (Trans. p. 30). Mr. Corbin testified that when

people asked his advice as to whom they would give proxies he told them to give them to Mr. Leonard. Mr. Osborn, a creditor, however, testified that Mr. Corbin solicited him to give his proxy to Mr. Leonard (Trans. p. 30). Mr. Leonard testified that he did not know who picked the Anglo-California Trust Company as the candidate, but that he called up the trust officer of the trust company because he had understood from him that the trust company had been requested to act. Mr. Leonard did not know who had requested the trust company to act as trustee (Trans. p. 31). Nor did Mr. Bradford know (Trans. pp. 32 and 33). Mr. Bradford, the chairman of the creditors' committee, is firmly of the opinion that Mr. McNab and Mr. Corbin ought to control the liquidation of the bankrupt's affairs in the bankruptcy court (Trans. p. 32).

Petitioners' attitude in their brief borders on the out and out claim that the referee abused his discretion when he disapproved the election of the Anglo-California Trust Company.

On the contrary, we believe that the referee was far too lenient and courteous under the circumstances. It is shown by the record, beyond question, that Gavin McNab is an attorney for and a director of the Anglo-California Trust Co.; that Mr. McNab is the chief counsel of the Continental Building and Loan Association, and has been so for many years; that Nat Schmulowitz, the attorney for the association in the bankruptcy proceeding, is an associate of Mr. McNab and a director of the bankrupt; that

George W. Mordecai, one of the directors, is an associate of Mr. McNab, and is the attorney for James McCullough, the president of the bankrupt; that A. H. Jarman, a director of the bankrupt, is an associate of Mr. McNab; that R. P. Henshall, the attorney for the Merchants' National Bank of San Francisco, which appears before this court in another proceeding wherein it seeks to control the election of the trustee, is an associate of Mr. McNab; that Mr. Leonard, the proxy holder who cast the vote for the Anglo-California Trust Co., is the president of a company of which Mr. McNab is a director and the attorney; and that all of these persons, with the exception of Jarman, made strenuous efforts to control the election, in conjunction with Mr. Wm. Corbin, who has been the general manager of the bankrupt for many years.

From these facts it is plain that Gavin McNab, and Wm. Corbin, who control the Continental in its life, do now endeavor to control it in its death; and we trust that this court will conclude, as did the referee and the district judge, that it is not for the best interests of the shareholder creditors, as a whole, to perpetuate, in the liquidation and final wind-up of the corporation, the control under whose management the Continental Building and Loan Association was compelled to seek the relief afforded by the bankruptcy court.

Even though the attorneys and officers of the bankrupt had nothing to do with the choice of the Anglo-California Trust Company, the referee well

says (Trans. p. 36) that he could not approve the choice because of the close business relations existing between Mr. Leonard, the proxy holder, Mr. McNab, the chief counsel of the bankrupt, and the trust company.

III.

THE LIQUIDATION OF THE BANKRUPT CORPORATION IS NOT A LIQUIDATION BETWEEN PERSONS CONSTITUTING THE CORPORATION, RATHER THAN A LIQUIDATION BETWEEN A BANKRUPT AND ITS CREDITORS, BECAUSE, UPON THE ADJUDICATION, THE STATUS OF THE SHAREHOLDERS CHANGED TO THAT OF CREDITORS.

The whole burden of petitioner's argument in their brief is based upon the proposition which is so well stated, and then refuted, by the referee in bankruptcy in his certificate (Trans. pp. 42-46):

"In view of the fact that the stockholders themselves choose the officers to manage their affairs, and that there is no capital stock other than the dues and sums paid in by the stockholders, there is much force in the contention that this proceeding partakes more of a liquidation between the persons constituting the bankrupt corporation than a liquidation between a bankrupt and its creditors, and that the usual rules governing relations between bankrupts and creditors do not apply; that the reason why bankrupts are not permitted to influence appointments of trustees is that the bankrupt's property passes from him, and he has no further interest therein, but remains subject to an examination and accounting to his creditors. He should, therefore, not have a voice in the naming of the person who is to investigate his acts; but in this case the identity of the bankrupt and the

creditors being one and the same, if the majority of the stockholders so desire, they should have the right to direct that the liquidation be conducted by their officers.

It is along this line of reasoning, I understand, that the officers and attorneys considered it proper for them to suggest a candidate for trustee, and to request the members to send authority to the president of the association to vote their claims.

I do not agree with this position, for the following reasons:

To assist members in building and paying for their homes was originally the primary object of building and loan associations, and the members took an active part in the management of the business. But such associations have developed commercially. Laws have been passed regulating their conduct in this state; the office of Building & Loan Commissioner is established by law, to examine into the affairs of such concerns—this, I take it, for the protection of the public dealing with them. An association, such as the Continental Building and Loan Association, having more than fifteen hundred members, with assets aggregating approximately a million dollars, is a great financial institution. The schedules herein show that it owes to Class C stockholders \$302,869. This stock does not represent monthly savings of its members, but is fully paid-up stock, paid in at the time the stock is issued. The member buying this class of stock receives a certificate with interest coupons attached, payable semi-annually and on which he receives 6 per cent on the money paid for his stock, but does not otherwise participate in the earnings of the association. This has all the features of a savings bank account paying 6 per cent interest (schedules, pages 4 to 22).

Class D stock, scheduled at \$46,013.34 as owing thereon, represents stock issued for money deposited subject to check drawn on the

association. This is substantially a commercial bank account (schedule, pages 59 to 61).

Class DC stock (schedules 49 to 55) is issued to borrowers and held by the association under assignment to it as security for repayment of loans. The DC stock referred to in pages 56 to 58, amounting to \$15,106 is similar to the last above-mentioned stock, being assigned to the association as security on payments of installments upon contracts of sale, instead of repayment of loans.

The other classes of stock are installment stocks, the holders thereof making monthly payment to the association. Class F. stock (schedules 23 and 44), amounts to \$291,087.48. Classes A, E and G (pages 45 and 46), amount to \$15,503.65. Class I (pages 47, 48), amounts to \$27,341.90. The total of installment stock is \$339,932.83. I refer to these classes of—stock to show the character of the business transacted.

Mr. Corbin has been general manager for many years, and Mr. Gavin McNab its principal attorney. It is obvious that the great body of stockholders do not take any active part in the details of the business. As in other large financial institutions, policies and business management of the concern are left to its officers whose duties and obligations are fixed by law. In this case, at the time of the filing of the petition the board of directors consisted of Mr. Corbin, its general manager; Mr. McCullough, its president; A. H. Jarman, George W. Mordecai and N. Schmulowitz; the three last-named being attorneys and associates of Mr. Gavin McNab, counsel for the association. It is my opinion that when such an institution, so managed and controlled, invokes the jurisdiction of the bankruptcy court to liquidate its affairs, a fair and impartial administration, including an investigation into the acts of the officers, if such investigation be-

comes necessary, requires that the trustee chosen shall be free from alliance with the corporation or any of its officers or attorneys, and that the officers and attorneys take no part in the selection of the trustee.

A further reason why in this case this should be strictly enforced is that since the association suspended active business, a partial liquidation has been had under the direction of its officers, as appears from the circular letter of August 5, 1915, sent out by the directors to the stockholders, announcing the filing of the petition herein, and which contains the following:

“Dear Sirs: Your Board of Directors enclose herewith a statement of affairs of your association. Since the attacks, made upon the Association by Building and Loan Commissioner Walker—the righteousness of which attacks was denied by the courts in judgments adverse to the Commissioner—your Board of Directors deemed it unwise to transact new business as continual official hostility would have made such course unprofitable to the stockholders.

Expenses were reduced as far as possible, and every effort was made to expedite liquidation. During this time there has been paid to the stockholders, in the order provided by law, over five hundred thousand dollars. As the assets of the corporation are in long-term mortgages, which cannot be called, and real estate, we consider this excellent progress.

We call the stockholders' attention to the fact that Commissioner Walker and his accountant stated that the Continental was insolvent, yet since these attacks were made the Association has paid out over five hundred thousand dollars, and has assets of more than eight hundred thousand dollars left, which will, properly administered, pay dollar for dollar to each stockholder.’ ”

This argument of petitioners, however, overlooks the fact that upon the adjudication in this case the status of the shareholders *changed* to that of creditors,—they ceased being shareholders—so that the proceeding assumed, as in other cases, the nature of a liquidation between a bankrupt, through its officers and attorneys, on the one side, and its creditors (the shareholders), on the other side. Petitioners concede (Petitioners' brief, pp. 13 and 14), that the shareholders have become creditors by reason of the adjudication in bankruptcy. Furthermore the bankruptcy courts are not concerned with the status of the parties before adjudication: they deal with the status after adjudication, which is always bankrupt and creditors; and in the case at bar the officers and attorneys of the Continental Building and Loan Association are now the bankrupt, and the former shareholders are the creditors.

It must be borne in mind that in the liquidation in bankruptcy of an ordinary commercial corporation, the stockholders are not arrayed against the creditors. They do not have to account to the creditors. It is the officers and attorneys of the corporation that must do this accounting on behalf of the bankrupt. If there has been mismanagement, assets concealed, or property fraudulently transferred, or the like, it is the officers and attorneys of the bankrupt that are responsible and must account both civilly and criminally, and not the stockholders. So, we say, the Continental Building and

Loan Association having become bankrupt, it is its officers and attorneys upon whom the burden rests to account in the bankruptcy court for the management of the bankrupt's property, and it is to the shareholders that this accounting must be made, since they have assumed, by reason of the adjudication, the status of creditors, and have ceased to be shareholders.

IV.

THE RULE THAT OFFICERS AND ATTORNEYS OF THE BANKRUPT MUST NOT INTERFERE IN THE ELECTION OF A TRUSTEE, IS BASED UPON SUBSTANTIAL REASONS, WHICH APPLY IN THIS CASE AS WELL AS IN OTHER CASES.

Petitioners say in their brief (Petitioners' Brief, p. 15):

“The courts have repeatedly drawn attention to the necessity of protecting the creditors against the bankrupt and have refused to approve elections accomplished in the interest of the bankrupt by the activities of its officers, directors, employees and stockholders.”

That bankruptcy courts have uniformly refused to approve trustees chosen through the influence of bankrupts or their attorneys, appears from the following cases:

In re John F. McGill, 106 Fed. Rep. 57;
5 Am. B. R. 155, 161;

In re Rekersdres, 108 Fed. Rep. 206; 5 Am.
B. R. 811;

Falter v. Reinhard, 4 Am. B. R. 782;

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In re Hanson, 156 Fed. Rep. 717; 19 Am. B. R. 237;

In re Sitting, 182 Fed. Rep. 917; 25 Am. B. R. 685;

In re Van De Mark, 175 Fed. Rep. 287; 23 Am. B. R. 760;

In re Wink, 206 Fed. Rep. 348; 30 Am. B. R. 298;

In re Morris, 154 Fed. Rep. 211; 18 Am. B. R. 828;

In re Ployd, 183 Fed. 791; 25 Am. B. R. 196.

Petitioners claim, however, that this rule does not apply to the case at bar, where the creditors are all shareholders and are creditors solely by reason of being shareholders. As we pointed out above (page 7), the shareholders changed into creditors upon the adjudication and are no longer to be treated as shareholders for any of the purposes of the bankruptcy proceeding. Petitioners in their brief concede that the shareholders have become creditors (Petitioners' brief, p. 14). All that is left of the bankrupt corporation, therefore, are its officers and attorneys, and it is they who must ac-

count, on behalf of the bankrupt, to the bankruptcy court and to the trustee selected by the shareholder creditors.

Petitioners, in attempting to avoid the application of the rule to the case at bar, ignore the *reason* for the rule, which is the real test to be applied. If the reason for the rule is as applicable to the case at bar as to other cases, then the rule should be applied, even though the case at bar is an unusual one and arose under peculiar circumstances. It is a familiar maxim of jurisprudence that when the reason of a rule ceases, so should the rule itself, but where the reason is the same, the rule should be the same (Civil Code Cal., Secs. 3510, 3511).

What then is the basic reason of the rule? Upon bankruptcy the bankrupt must account to his trustee for his management of his property, for concealed assets, if any, for property fraudulently transferred, if any, for preferences given, if any, and the like.

In the case of *In re Hanson*, 156 Fed. Rep. 717, 718; 19 Am. B. R. 237, the court said:

“It is well settled by all the authorities that the trustee represents the creditors, and not the bankrupt, in the administration of the estate; and that it is improper that the bankrupt shall actively interfere with the matter of his selection and appointment; and that, if he does interfere and the person aided by him is appointed by votes procured by such interference, the appointment should for that reason be disapproved. * * * The rule is a salutary one, and based on obviously sound reasons. It often happens that it becomes the duty of the

trustee to actively antagonize the bankrupt by efforts to discover secreted assets, or to set aside conveyances as fraudulent, or to recover preferences. There should be no color or basis for suspicion of any partiality or sense of obligation on the part of the trustee toward the bankrupt. Hence, however high the character of a proposed trustee may be, the active interference of the bankrupt in favor of his appointment will render him practically ineligible to appointment as trustee in bankruptcy."

As was said by Judge Dooling in *In re Forestier*, 222 Fed., pp. 537, 538; 35 Am. B. R. 51, 52:

"It is not important, in a particular case, to determine that the interests of the bankrupt and the trustee will necessarily conflict. The important question is *may* they conflict."

In the case of *In re Rekersdres*, 108 Fed. Rep. 206; 5 Am. B. R. 811, the court said:

"The trustee should be the free and unbiased choice of the creditors and not be influenced by any other interest. *Falter v. Reinhard*, 4 Am. B. R. 782; *in re McGill*, 5 Am. B. R. 155, 106 Fed. 57. * * *. A trustee should be wholly free from all entangling alliances or associations that might in any way control his complete independence and responsibility."

As we have seen, it is the officers and attorneys of the bankrupt that must do this accounting in the case at bar. Furthermore, these officers and attorneys, for more than three years prior to bankruptcy, conducted a partial liquidation of the affairs of the corporation involving the distribution of over \$500,000.00 to shareholders, and during this time no new business was transacted (Trans. p. 46). This liqui-

dation must all be accounted for to the bankruptcy court, and to the trustee in bankruptcy. *Would it not make the administration of the bankruptcy act a vain and impotent thing, and merely a pro forma proceeding, if the officers and attorneys of the Continental Building and Loan Association could select directly or indirectly the trustee to whom they are to make this accounting? Are they to be permitted to investigate, as trustee, or through a trustee selected by them, their own account?*

It has been the uniform practice of courts having to do with the liquidation of estates not to allow a person to occupy a dual position, in which he must account to himself (Williams on Bankruptcy, 9th ed., p. 85). Yet this is exactly what petitioners are seeking to accomplish here, indirectly, it is true, but with the same consequences as if directly. The law would be a sham if it permitted to be done indirectly what it forbade to be done directly. In the unreported case of *In re Charles Schulz* (D. C. Northern Dist. of Cal., decided May 21, 1915), where the bankrupt made an assignment for the benefit of creditors prior to bankruptcy, and the assignee and his attorney attempted to control the election of the trustee in bankruptcy, Judge Dooling said:

“It is the policy of this court that a trustee in bankruptcy shall be absolutely free in fact and in law to require a settlement from an assignee of the bankrupt and to secure such absolute freedom it will not permit the selection of a trustee by or through the assignee of his attorney.”

Does not the rule enunciated by Judge Dooling apply with redoubled force to the case at bar, where the officers and attorneys of the Continental Building and Loan Association occupy a position similar to that of the assignee and his attorney in the Schulz case?

V.

THE MAJORITY CREDITORS HAVE NOT BEEN DEPRIVED OF THE RIGHT TO SELECT A TRUSTEE, BUT MUST NOT, AS AGAINST THE OBJECTING MINORITY, SELECT A TRUSTEE CONNECTED WITH THE FORMER MANAGEMENT OF THE BANKRUPT, EITHER DIRECTLY OR INDIRECTLY.

Petitioners seem to take the position in their brief that the majority creditors have been deprived of their *unquestioned* right to select the trustee. This is answered by the referee, who says, in his certificate (Trans. p. 35):

“I would be pleased to have the creditors herein select as trustee a financial institution of equal standing with the Anglo-California Trust Company, but because of its relations with the bankrupt, and the association with it of attorney of the bankrupt, it is my opinion that it should not be the trustee herein.

The stockholders first represented by Mr. McCullough, then by Mr. Leonard have the power, in number and amount, to name the trustee. They have not been deprived of the right of exercising that power, but I hold that they must choose a disinterested person, and that the choice shall be their choice and not that of the officers or attorneys connected with the former management of the bankrupt.”

The minority have the right to be heard, however, and, under the circumstances of this case, where it appears undisputed that the Anglo-California Trust Company was selected through the active efforts of the officers and attorneys of the bankrupt, and that Gavin McNab, chief counsel of the bankrupt, is a director of the trust company and one of its legal advisers, and that the trust company is trustee under all the deeds of trust securing the bankrupt's loans, the majority cannot force this choice on the objecting minority, because it comes too near to a continuation of previous conditions to be warranted.

In the case of *In re Gordon Supply & Manufacturing Co.*, 129 Fed. Rep. 622; 12 Am. B. R. 94, the court said:

“There can be no objection personally to the trustee who has been chosen by a majority of those interested in the estate, at the creditors' meeting; and the right to such majority under ordinary circumstances to control the matter must be conceded. The trustee is the representative of creditors and they are the ones to decide who he shall be, subject only to the right of the court to supervise the choice where it is objected to. In the present instance the trustee chosen is not only a stockholder in the bankrupt corporation against which the proceedings were instituted, but he has been admittedly associated closely as attorney and legal adviser with those who have been hitherto in control, and their management is not only the subject of criticism, but may call for action on the part of the trustee to hold them personally responsible. To approve of the trustee now selected comes too

near, therefore, to a continuation of previous conditions to be warranted. With so many others who would be fully as efficient and entirely acceptable, the majority have no right to impose their present choice on the objecting minority."

The effect of Referee Kreft's ruling, therefore, is simply that the majority creditors must pick a disinterested trustee, one not elected through the influence of, or in any way connected with, the former management of the bankrupt.

Woodman in his "Law of Trustees in Bankruptcy" (Chapter 1, Sec. 11) says: "It is well settled that the trustee should be free from all entangling alliances" and cites many cases in support of this doctrine.

Petitioners further claim that the referee's ruling prevents shareholders favorable to the conduct of the liquidation by the officers and attorneys of the bankrupt, and especially Mr. Wallace Bradford, from voting. This is not so. What the referee does say is that such shareholders, while they may suggest whom they please for trustee, and may vote for whom they please for trustee, are not the proper persons to organize and lead the creditors for the purpose of choosing the trustee. They have the right to vote at all times, and they have not been, and will not be deprived of that right.

VI.

EVEN IF THE ELECTION HAD NOT BEEN DIRECTED, MANAGED OR CONTROLLED BY THE OFFICERS OF THE BANKRUPT, THE ANGLO-CALIFORNIA TRUST COMPANY WAS DISQUALIFIED BECAUSE IT IS THE TRUSTEE UNDER ALL THE DEEDS OF TRUST SECURING THE BANKRUPT'S LOANS.

One of the objections raised at the first meeting of creditors on September 15, 1915, to the approval of the election of the Anglo-California Trust Company, was that it was trustee upon the deeds of trust which secured the bankrupt's loans (Trans. pp. 23, 24). It has been a common rule of all courts, having to do with the liquidation of estates, not to permit a person to occupy a dual position where he must account to himself (Williams on Bankruptcy, 9th Ed., p. 85). This is the basis of the rule that the bankrupt cannot select his trustee. It has been applied even to assignees and receivers who seek to be trustees (In re Clay, 192 Fed. Rep. 830, 833; 27 Am. B. R. 715, 719).

What is not allowed to be done directly, cannot, of course, be allowed to be done indirectly, and so bankrupts and assignees are not allowed even to influence the selection of trustees. They must hold hands off (In re Forestier (D. C. Cal.), 222 Fed. Rep. 537, 538; 35 Am. B. R. 51, 52; in re Schulz (D. C. Northern Dist. Cal.), decided May 21, 1915).

In the case at bar, the Anglo-California Trust Company, if its election as trustee in bankruptcy stands, would be in the anomalous position of accounting *for itself*, as trustee under these deeds of

trust, *to itself*, as trustee in bankruptcy. For this reason, alone, the election of the Anglo-California Trust Company was properly disapproved by the referee.

VII.

TO DISQUALIFY A CANDIDATE FOR TRUSTEE IT IS NOT NECESSARY TO SHOW THAT THE ACTIVITY OF THE BANKRUPT ACTUALLY INFLUENCED THE CREDITORS—THE ACTIVITY OF THE BANKRUPT IS SUFFICIENT.

Petitioners in their brief (Petitioners' Brief, p. 22) state that a mere attempt to influence an election is not sufficient unless it has actually had that result, and that there is not one word of evidence to show that any of the creditors who voted for the majority candidate was actually influenced by any of the acts of the bankrupt's directors and attorneys. Petitioners cite in support of this statement the case of *In re Eastlack* (D. C., N. J.) 16 Am. B. R. 536, 145 Fed. 168.

This proposition is refuted by Remington, in his work on bankruptcy, when he says:

“The election of a trustee in the bankrupt's own interest should be disapproved. It is the policy of the bankruptcy law to take the management of bankrupt estates out of the hands of the bankrupts themselves. The bankrupt has no right to influence the choice of a trustee and he has no voice in the election. Accordingly interference by the bankrupt, the voting of claims in his interest or at his direction, should be discountenanced and held to invalidate the choice of a trustee thus secured * * *.”

And it has been held, apparently, that some showing of actual influence must be made, and that only such votes as were so proved to have influenced should be rejected and that the mere existence of such relation is not of itself a disqualification (quoting from *In re Eastlack* (D. C., N. J.) 16 Am. B. R. 536, 145 Fed. 68; *In re Lloyd* (D. C., Wis.) 17 Am. B. R. 98; and in *re Kaufman* (D. C., Ky.) 24 Am. B. R. 117, 179 Fed. 552).

But if the cases in re Eastlack, in re Kaufman and In re Lloyd are to be interpreted as to laying down the rule, they are not to be approved. Such proof would be almost impossible to produce, and the clever and more dangerous the collusion the more difficult would it be to disqualify the particular voter or candidates who have colluded."

Remington on Bankruptcy, 2nd Ed., Vol. 1,
Sec. 887.

VIII.

DIRECTORS, OFFICERS AND STOCKHOLDERS OF ORDINARY CORPORATIONS CANNOT EVEN VOTE THEIR INDIVIDUAL CLAIMS FOR TRUSTEE WHERE THERE HAS BEEN COLLUSION OR IMPROPER INFLUENCE.

Petitioners in their brief state (Petitioners' Brief, p. 21):

"Yet even in an ordinary bankruptcy, where the bankrupt and the creditors are not identical and an election in the interest of the bankrupt is not an obvious impossibility, directors, officers and stockholders who are bona fide creditors may take part in the election of trustee and may suggest the trustee."

This proposition is refuted by Remington, in his work on bankruptcy, when he says:

“In one case it was held not improper to elect a director of a bankrupt corporation as one of three trustees (in re Syracuse Paper and Pulp Co., 21 Am. B. R. 174, 164 Fed. 275, (D. C., N. Y.)). But the decision in the case in re Syracuse Paper and Pulp Co., was undoubtedly based on the fact that there were three trustees elected two of whom in no way occupying inconsistent positions, the third trustee being chosen merely as a convenience because of his familiarity with the details of the bankrupt’s business. To extend the doctrine enunciated in that case to cases where only one trustee is elected would be subversive of proper administration and be a shock to the moral sense as well, for that ‘one cannot serve two masters’ is both sound sense and good law * * *.

Yet directors, stockholders and employees of bankrupt corporations are entitled to vote, *and the evil of permitting the action of a majority in number of creditors to be controlled by the vote of an officer or stockholder having a large claim can be sufficiently guarded against by the discretion vested in the referee to refuse a vote to such claimant in cases of collusion or improper influence.* In re Stradley & Co. (D. C., Ala.) 26 Am. B. R. 149; 187 Fed. 285.”

Remington on Bankruptcy, 2nd Ed., Vol. 1, Sec. 887.

IX.

PETITIONERS DO NOT SHOW THAT THEY WERE IN ANYWISE
PREJUDICED BY THE ORDER OF WHICH THEY COMPLAIN.

There is nothing in the record to show that peti-

tioners, or any of them, were prejudiced by the orders of the referee and the district judge. For aught that appears in the record they may have voted for Williams, or the Union Trust Company, the opposing candidates for trustee. There is nothing in the record to show that they voted for the Anglo-California Trust Company, whose election was disapproved, and of which disapproval they complain.

X.

THE REFEREE'S RULING WAS NOT MADE FOR THE BENEFIT OF ANYONE OTHER THAN THE STOCKHOLDERS THEM- SELVES.

Petitioners in their brief (Petitioners' Brief, p. 23) use up a lot of space in attempting to show that the referee's ruling was made to help out the State Building & Loan Commissioner. This violent assumption is absolutely false and has not the shadow of support in fact or in anything appearing in the record. The State Building & Loan Commissioner was not a candidate for trustee and had nothing to do with the election. Furthermore, Mr. W. R. Williams entered the campaign for trustee not as State Superintendent of Banks, but as an individual. The State Superintendent of Banks and the State Building and Loan Commissioner have no official standing before the bankruptcy court and no one contends that they do.

CONCLUSION.

For the foregoing reasons, we respectfully submit that the order under review should be affirmed.

Dated, San Francisco,

March 21, 1916.

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